THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 356 **JANUARY 2003**

There is currently a general belief that recent economic management has been brilliant. The long period of growth experienced by the United States is generally assumed to cast great credit on the Federal Reserve. But there is an alternative view, that the recent management of the economy has in fact been abysmal, and therefore provides a very worrying precedent for the future… Evidence of history suggests that allowing an asset bubble to develop is the greatest mistake that a central bank can make. Over the past five years or so the Federal Reserve has knowingly permitted the development of the greatest asset bubble of the twentieth century.

Andrew Smithers & Stephen Wright, *Valuing Wall Street*, 2000

CALM BEFORE THE STORM

Apparently, it cannot be emphasized often enough that the United States faces an economic situation that is unique in postwar history: a recession generated not by tight money and a credit crunch, but by severe dislocations and maladjustments in its economic, financial and price-cost structures.

It should go without saying that a serious assessment of the U.S. economy's prospects is only possible if based on a clear understanding of what those structural dislocations and maladjustments are and, above all, to which causes they are attributable. Both their kind and their size are important.

Reading a deluge of reports about the U.S. economy, we note an abundance of forecasts, overwhelmingly more or less optimistic, but a virtual absence of critical research.

There is simply a preconceived opinion that the U.S. economy possesses strong fundamentals and moreover the greatest flexibility to cope with any economic maladjustments, enabling it to overcome the economic downturn better than all other countries. Fed Chairman Alan Greenspan's hype and extreme monetary looseness has created multiple bubbles. One of them is a highly resistant bubble of optimism.

If the present U.S. economic downturn has not been caused by a credit crunch, as has been the usual experience in the past, then what else has been causing it? We don't think that any reasonable assessment of the economy's prospects is possible without such knowledge.

Recessions are the phase in the business cycle during which businesses and consumers correct the excesses and maladjustments in their borrowing and spending that have accumulated during the boom. Plainly, this is the indispensable condition of a return to new, lasting economic growth.

These considerations raise two all-important questions about U.S. economic prospects. The one is about the specific, extraordinary causes of this economic downturn; and the other one is whether or not, and to what extent, these causes have been effectively corrected and removed.

As to the causes, we have extensively investigated and described them in past letters. The obvious, single most important cause is corporate America's profit crisis, being the decisive depressant of business investment. Yet, just by itself, this still explains nothing. Essentially, the profit crisis has its own causes that need exploration.

Of the same vital importance is, of course, the second of the above-mentioned questions concerning the necessary post-bubble adjustments and the remedial treatment of the existing, growth-impairing economic and financial dislocations and maladjustments. The fact that the U.S. economy has grown a remarkable 3.2% over the year to the third quarter of 2002, and even 4%, at annual rate, in that quarter, has greatly reinforced optimism

about its further recovery and long-term performance.

But as we have repeatedly explained, this economic upturn had far too little thrust and such an ill-structured pattern that it had to be written off long ago as a recovery that could only abort. Our April letter carried the title *Bogus Recovery*. Cyclical recoveries, by the way, typically start with high speed during their first two years.

THE GREAT POLICY FAILURE

Later on we shall delve deeper into the question of what we regard as the U.S. economy's specific, major growth-impairing dislocations and their causes. First, though, we would rather take a closer look at the recent upturn and the present situation.

For the time being, the consensus is satisfied that the U.S. economy has experienced its shallowest recession in the whole postwar period and a recovery that has distinctly outpaced economic growth in the rest of the world. It is being registered with great applaud that the government and Federal Reserve have promptly treated the economic downturn with unprecedented massive monetary and fiscal stimulus. Money and credit keep expanding at breathtaking rates. Not only that, but on top of extremely loose money and credit stance, the government's fiscal stance took a record swing from a budget surplus of $1273 billion in 2001 to a deficit of $159 billion in 2002, or 2.8% of GDP.

If not for this huge monetary and fiscal boost, the United States would surely have had a deeper recession and a slower recovery. But unfortunately, in this case *some* success is not enough. The two key questions to ask at this juncture are whether or not these aggressive policies of demand stimulation have succeeded or failed in putting the economy back on a path of sustained, self-reinforcing growth; and next, what should we look at in case of failure?

Our introductory, brief answer is: By now, it is plainly evident that the Fed's extremely aggressive monetary easing, slashing short-term interest rates to their lowest level in 40 years, and associated massive tax cuts have failed miserably in their crucial objective of sparking a broad, self-sustaining economic recovery. Most ominously, they have even failed to stop the wealth carnage in the stock market, now entering its fourth year.

Compared with the poor growth rates in the rest of the world, the U.S. economy's recovery over the past year may look quite impressive, but compared with the norm of postwar cycles, it was a flop, lacking everything that could make it self-sustaining.

Considering, however, what has actually happened during the recovery to resource allocation, jobs, profits and general indebtedness, it is a compelling conclusion that the U.S. economy is in even worse shape today than a year ago when the recovery began.

It is a terrible statement to make, but instead of the necessary post-bubble adjustments, there have been rather more of the same bubble-related maladjustments in the way that consumption has continued to boom at the expense of business fixed investment, as the housing bubble has taken over from the stock market bubble.

TO REPEAT: A PHONY RECOVERY

Literally nothing in this recovery has been normal. It was unusually slow and, above all, of a most unusual pattern. Extraordinary strength in consumer spending, fueled by the housing bubble, coincided with persistent, extraordinary weakness in capital spending. Never before has the consumer spent with such reckless abandon in a recession. While his income growth slowed to a sluggish annual rate of little more than 2%, his rate of new borrowing accelerated to 9% and higher.

During the third quarter of 2002, private households added a record annualized sum of $770 billion to their debts. For comparison, 1998 was the first year in which they added an annual debt load of more $400 billion. Total consumer incomes, on the other hand, increased overall by just $294.2 billion, of which only $89.9 billion were from salaries and wages.

In actual fact, however, it was a consumer spending boom only in light of drastically diminished expectations. Compared to the preceding years and compared above all to the norm of postwar cyclical

recoveries, it was sub-par growth even in consumer spending, and for an obvious reason: America had its first jobless economic recovery in postwar history.

Yet the decisive failure of the recovery shows in the protracted weakness in business fixed capital investment. Policymakers had hoped for its prompt rebound, making the recovery self-sustaining. Sharp rises in business fixed investment, particularly in equipment, have been typical of all cyclical recoveries in the past. This time, in diametric contrast, it has continued to fall, though at a slower pace than before.

Most importantly, however, it was a profitless recovery. Profits of corporations in the nonfinancial sector were down to $321 billion in the third quarter of 2002, compared with $358.7 billion in the same quarter a year ago. Declining profits during an economic recovery is another unprecedented experience.

STILL MORE BUBBLE TROUBLE

What went wrong exactly with the U.S. economic recovery? We see several major failures, of which one ranks top in our view. That is the current account deficit's continuous surge. We have to emphasize this again and again because the consensus among policymakers, economists and investors in America discards it as the harmless counterpart of foreigners wishing to invest in America, involving no damaging effects of any sort for the U.S. economy. Although the strong dollar was obviously hurting manufacturing, this damage is supposed to be greatly outweighed by the positive effects on prices and the financial markets.

Considering that this deficit is approaching $500 billion, or almost 5% of GDP, this complacency about its economic implications is perplexing. During the four quarters until the third quarter of 2002, it has been up a stunning $120 billion, or 38%, from $312.6 billion, at annual rate, to $432.6 billion. This net increase in imports resulted from a rise in imports by $149.6 billion and a rise in exports by only $29.6 billion.

As we have repeatedly stressed, the most important effect of the huge and soaring U.S. trade deficit is that higher spending on imports is implicitly at the expense of domestic business revenues, and thus ultimately at the expense of profits. In essence, it is an income leakage, impacting both consumers and businesses. In order to offset its massive drag on the domestic income circulation, it needs ever larger domestic credit creation.

Continuous profit carnage is the U.S. economy's one major problem; gross distortions in its demand growth is the other. It is hard to imagine an economic recovery that could be more ill-structured in its pattern. During the four quarters of the U.S. economy's recovery until the third quarter of 2002, overall U.S. GDP increased in current dollars by $406 billion. This had three main sources: personal consumption (+$376 billion), government spending (+$130 billion) and inventories (+$75 billion).

Together, they would actually have made a boom-like recovery, if it had not been for two subtractions from GDP growth. The one came from declining private fixed investment, both residential and non-residential, subtracting $55 billion, and the other one came from the exploding current-account deficit, subtracting another $120 billion from GDP growth.

The fact is that policies and economic forces in the United States are not at all working toward balance, but toward worsening imbalance. Mr. Greenspan is desperately fighting the recession with still more consumer borrowing and spending excesses.

AMERICA'S ADJUSTMENT PROBLEM

There is a widespread, comforting view that slumping business investment reflects a desirable correction of prior, excessive capital spending and a corresponding oversupply. As savage international competition, ample global capacity and sound monetary policy are holding down prices, Corporate America is slashing its excess capacity. At least that is the comforting conclusion. Inherently, this view puts the investment slump in a highly positive light with the happy conclusion that vanishing excess capacity is paving the way for the next investment boom.

It is truly an absurd misjudgment of America's effective adjustment problems. Of the three aggregates of final demand — private consumption, fixed investment and government spending — only one has grown faster,

much faster, than GDP, sharply increasing its share of the total, and that is private consumption.

But such a sizable increase of consumption as a share of GDP does, of course, not happen in a vacuum. Essentially, the required resources had to be pulled from elsewhere. The one counterpart was weak net investment, and the other one was the soaring trade deficit, supplying foreign goods. What the surging chronic trade deficit obviously reflected was not domestic overinvestment, but rampant overspending on consumption and lack of productive capacity, reflecting undersaving and underinvestment.

While Mr. Greenspan excuses his tolerance of the bubble with the impossibility to recognize one before it bursts, the economic distortions deriving from the asset bubble were always conspicuously evident in the plummeting rate of personal saving and the soaring share of consumption in GDP growth.

It strikes us as most ominous that the sharp slowdown in U.S. domestic demand growth coupled with broadly declining utilization of production capacity has flatly failed to put a brake on the import surge. Total exports were up 1% year-over-year in the third quarter to $312 billion, while total imports surged 10% to $426.7 billion. Indicative of how out of whack the trade situation has become, third-quarter goods imports totaled $298.9 billion, 70% larger than the $175.7 billion goods exports.

It is certainly a highly disturbing occurrence, suggesting in the first instance that America's monstrous trade deficit is not only a problem of excessive domestic demand but also a problem of insufficient supply, that is, of lacking supply capability, due to insufficient investment in manufacturing.

THE TRADE DEFICIT IS STRUCTURAL

Observing the protracted lag of U.S. exports during the past few years, it has been our premise for many years that the exploding trade deficit must have an important cause also in chronic underinvestment in export industries.

As a matter of fact, we have a very simple way to make a reasonable assessment in this respect. We compare overall U.S. domestic demand growth with the simultaneous rise in the manufacturing sector's net capital stock. Overall, this deficit is overwhelmingly an imbalance between exports and imports of manufacturing goods.

The relevant fact is that domestic demand growth has been vastly outpacing the rate of capital stock growth in manufacturing for years. Growth of domestic demand during the latter part of the 1990s averaged 4.3% per annum, while growth in the net capital stock of manufacturing averaged just 2%. While fixed net capital investment as a whole has been growing at an annual rate of slightly over 3%, its pattern has been heavily lopsided towards trade, finance and services — in other words, towards serving the consumer.

This grossly distorted investment structure is hardly surprising considering the grossly distorted structure of domestic demand growth. It strongly suggests that America's trade deficit is a far bigger structural problem than is generally assumed. One of the obvious grave implications, for example, is that a dollar devaluation for lack of domestic productive capacity would do very little to improve the trade balance.

Since the 1920s America has traditionally been a high-consumption, low-saving and low-investment economy. From a macro perspective, such an economy should also be a low-profit economy.

CAPITAL INVESTMENT IS PARAMOUNT

It used to be elementary knowledge among economists that rising investment in tangible assets — factories, offices, machinery and other forms of equipment — is paramount for economic growth and general prosperity. First it generates demand, employment, incomes and tangible wealth while the factories and the equipment are built and produced. Once the capital goods are installed, they increase supply, employment, incomes and productivity. The key point to see is that investment is the one and only GDP component that adds both to demand and supply.

A NEW BORROWING ERA

Following the inner-American discussion about the U.S. economy, several peculiarities strike us. There is, first of all, an unusual emphasis on consumption as the prime mover of economic growth, and there is furthermore a general disregard of what is happening to saving and capital accumulation. Alternatively, the emphasis is on autonomous changes in productivity growth through new technologies as the root cause of economic growth and profitability.

This is a radical departure from the thinking of the old economists. Measured by the rate of productivity growth, the U.S. economy appears to be in excellent shape, definitely better than the whole rest of the world. But measured by its record-low rates of saving and capital accumulation, it is in most miserable shape. What is the right interpretation?

Looking at the whole postwar period, the United States actually experienced its most vigorous and definitely its most healthy economic performance in the 1960s. Its rates of national saving and of capital investment were then at their highest in the whole postwar period, and so were its rates of business profits. The main purpose of moderate borrowing on the part of the consumer at the time was the financing of new homes, and the main purpose on the part of businesses was the financing of new investment in plant and equipment, that is, in tangible assets. In essence, it was overwhelmingly borrowing for capital formation.

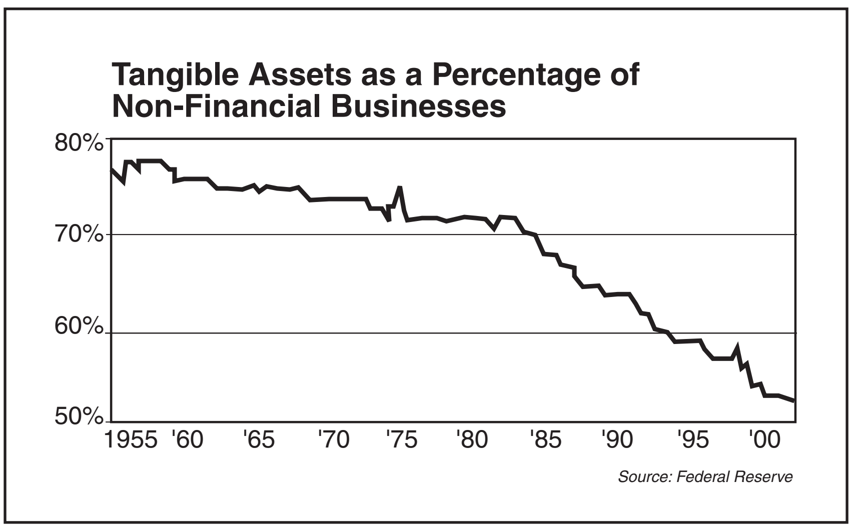
This pattern of borrowing began to change gradually in the 1970s and rather dramatically in the 1980s. From then on, debt growth went exponential. Consumer debts have since skyrocketed by 473% and business debts by 382%. These numbers compare with simultaneous GDP growth by 283%.

A drastic change in the use of the new debts was the other striking new feature of the developing borrowing binge. Exploding credit quantity implied plunging credit quality.

Consumers started to borrow like crazy to finance increased current spending, and businesses borrowed like crazy no longer to invest in plant and equipment, but to finance financial transactions — mainly leveraged stock buyouts, mergers, acquisitions and stock repurchases — that were thought to be more appropriate for quickly raising shareholder value.

While these policies worked splendidly in instantly boosting share prices, it was just as clear right from the beginning to a reasonable observer that they inherently ravaged corporate capital formation and balance sheets. But with the quickest possible maximization of shareholder value as the accepted overriding goal of corporate management, these damaging effects found little or no interest.

A few numbers highlight the drastic changes in the balance sheets of nonfinancial corporate businesses during these years. Between 1996–2001, this sector increased its indebtedness by 50%. But most importantly, this went together with a dramatic shift between tangible and intangible assets. Fifty years ago, tangible assets — mainly plant and equipment — represented 78% of the assets of nonfinancial corporations. Today, their proportion is down to 53%.



Strikingly, the biggest part of this shift in corporate asset composition happened quite abruptly only recently during America's recent bubble years. Between 1996–2001, a rise in corporate tangible assets by $1,653 billion compared dismally with a simultaneous steep rise in financial assets by $3,603 billion.

SHAREHOLDER VALUE SPIN

But the most disastrous part in this development appears in the Fed statistics (Flows of Funds Accounts) under the mysterious title "Miscellaneous assets," with $2,826.9 billion accounting for the bulk of the increase in financial assets. What this item largely reflects is no secret — mostly worthless so-called "goodwill," being the capitalized difference between what companies paid to acquire other companies and the net worth of those acquisitions as reported on their balance sheets.

According to shareholder-value spin, the typically large premiums that acquiring firms paid on top of the high market price of the acquired firms' stocks had their justification in the big future gains in operating efficiency and future profits through grand synergies expected to result from the mergers and acquisitions. Dealmaking triumphed over organic growth through investment.

It was always a complete mystery to us how so many people in top positions of the American economy could seriously believe in the economic nonsense that America's new dealmaking capitalism was trumpeting and executing. To us, it shattered records in capital destruction. During its three busiest years, 1998 to 2000, deals totaled nearly $4,000 billion, more than in the preceding 30 years.

Of course, the trillions of dollars that the corporations accumulated on their asset side as goodwill were mere book entries earning nothing. As the expected grand synergies, in general, never materialized, the reality is their total worthlessness. The only real thing in this whole exercise was and is, after all, only one thing — the unprecedented surge of debts incurred and the related interest bill, ravaging profits in the long run.

In hindsight, it is plainly obvious that Corporate America emerges from these shareholder value follies with three main structural damages: first, lowered profitability; second, lowered capital formation; and third, drastically weakened balance sheets.

THE FORGOTTEN NEED FOR SAVING

No less drastic were the changes in the behavior and the finances of the consumer. On the surface, his finances look far better than those of the corporate sector as the vertical rise in indebtedness was more than outpaced by the combined rise in market values of houses and corporate equities. Even though the consumer's net worth has modestly declined since the second quarter of 2002, it is still sharply up since the mid-1990s. The question is how quickly these market values will fall, if the U.S. economy weakens again.

Our immediate particular interest, however, is in the macroeconomic dislocations and distortions that are plaguing the U.S. economy in the post-bubble aftermath. In the case of the consumer, this macroeconomic damage resides mainly in his massive dissaving, as reflected in the extraordinary plunge of the personal saving rate to almost zero in 2001.

Ever since firms and retailers invented consumer installment credit in the 1920s, U.S. economic growth has become heavily geared to consumer spending and borrowing. But this traditional consumption bias took a big leap in the 1980s and in particular in the late 1990s. The most striking characteristic of both periods were exploding consumer debts and collapsing national saving.

In the 1980s, in actual fact, the hemorrhage of national saving had caused great and widespread concern. Many American economists expressed their strong misgivings about the implicit negative effects on capital investment. This time, in diametric contrast, nobody seems to care or even take notice.

There seems to prevail a widely accepted view that credit creation makes old-fashioned saving from current income superfluous. As to the equal utter lack of interest in capital formation, the apparent explanation is a singular focus on productivity growth. Why are saving and investing even necessary, if the U.S. economy is enjoying stellar productivity growth without them?

What's wrong with this view? In short, everything. It's macroeconomic nonsense.

What really induced generations of economists of all schools of thought to elevate saving to an indispensable, key condition for economic growth? The basic reason is that it is the limiting factor for capital investment. Short of nirvana, all resources are scarce. Due to this elementary wisdom, new capital investment can only come about to the extent that somebody makes the resources for the production of the capital goods available. That somebody happens to be mainly the consumer. By saving, that is, by spending less than he earns, he effectively releases the necessary productive resources for investment.

But this necessary release of productive resources is true only for saving from current income, coming implicitly from current production. The attendant release of resources is what makes this kind of saving indispensable for investment and economic growth. In essence, capital formation represents the surplus of production over consumption, and that has to be made possible by saving.

In today's America, there apparently prevails a very fuzzy conception of the essence and function of saving in the macroeconomic growth process. Typically, people think of it exclusively in terms of finance. But that is by no means the key aspect.

Manifestly, nothing is easier than to replace a lack of savings with credit creation. But this does not replace savings in the sense of releasing productive resources for the production of capital goods. From this perspective, falling savings imply falling investment.

The latter is precisely what happened in the United States during the late 1990s. As the bubble-driven consumption boom slashed available savings, it correspondingly slashed the portion of GDP that can be devoted to net investment. This is implicit. To quote Friedrich Hayek on the subject: *"Saving is not synonymous with the formation of capital but merely the most important cause which normally leads to this result."*

We have elaborated this fact for two reasons: first of all, it makes compelling evidence for our view that the present investment bust in the United States has nothing to do with a prior investment boom. If there was one, it was exclusively in the small sector of the new information technology. Across the economy as a whole, there has essentially prevailed gross underinvestment. But above all, this recognition raises the question of the true causes of this investment slump.

PRODUCTIVITY GROWTH IS NO PANACEA

Before delving into this question, we have to make some critical remarks about productivity growth. For America's policymakers and economists, it seems to be the great magic that solves all problems and that will sustain the economic recovery. It seems to be a widespread view that the measured stellar productivity growth is the main warrant of a mild recession and of an impending recovery.

It happens that today's American policymakers' and economists' exceedingly high esteem of productivity growth as the most important source of economic growth is in diametric contrast to the traditional, striking neglect traditionally found in economics.

The crucial point to see about productivity growth is that, by itself, it only means that hours worked have risen less than real GDP. But there is nil economic merit in this effect unless it is accompanied by an improvement in some other kind of the economy's performance such as growth of output, profits or investment. In the case of the United States, in actual fact, everything else is deteriorating. That is probably the main reason for the general, singular focus on productivity growth.

In short, productivity growth is not the panacea for which American policymakers and most economists seem to take it. If there is insufficient demand, as today, increasing productivity can only result in increasing numbers of unemployed workers, declining capacity utilization and, ultimately, slower growth.

The one and only thing that is able to lead the U.S. economy — and any other economy, of course — out of the present sluggishness is demand creation, either through borrowing for consumption or for capital investment. But we see nil possibility for either, both in the United States and in the rest of the world.

THE SAME OLD PROFIT ILLUSIONS

The consensus view holds that the U.S. economy, after a brief pause in the fourth quarter, is poised for a sustained recovery in 2003 with solid 3% growth, low inflation and strong productivity growth. In general any possibility of a new dip into recession is flatly repudiated. New double-digit growth in profits is supposed to stabilize the stock market, providing gains in stock prices. Japan and Europe would love to have this performance.

Forecasts of American economists keep surprising us with their lack of explanation or information about underlying assumptions. It seems to be a pure numbers game. The main rule seems to be to extrapolate any upward move, however small and brief. Declines are principally discarded as soft spots.

We see a lot more than a soft spot. The profit performance has been miserable during the recovery. There is nothing in sight that suggests a recovery in business fixed investment. And consumer spending, which has held up well so far, is unlikely to provide an upside for economic growth.

Our particular emphasis is on the dismal outlook for profits. It has been the popular mantra for years and years that American corporations were gathering stellar profits through the widespread application of new information technology and superior "corporate governance," a phrase never heard before.

Meanwhile, the celebrated profit miracle has been exposed as a systematic profit fraud. To meet their trumpeted, excessively ambitious, profit targets, the management of numerous companies resorted to many kinds of accounting tricks in order to boost their stock prices. It emerges that some 250 American public companies will have to restate their accounts this year.

Although profits have slumped as never before, the new profit forecasts are little different from those of the past. No Wall Street economist, apparently, is ever able to think of less than double-digit profit growth. Estimates have been scaled down, yet remain 15–20% absurdly high.

Positive profit reports, nevertheless, keep abounding, but only by measuring reported profits against drastically reduced market expectations. In essence, it remains the very same old game: to cheat investors. Even then, more and more profits fall below the drastically lowered measure of manipulated expectations.

THE PROFIT BRAKE

As we have articulated many times before, the U.S. economy's present downturn is fundamentally different from all its predecessors. They all originated primarily and mainly in a money and credit crunch, implemented by the Fed in response to rising inflation.

As the current downturn has plainly happened against the backdrop of exploding money and credit growth, it essentially has a totally different deterrent. The most visible and also most plausible cause is the worst profit slump since the Great Depression of the 1930s. If businesses see insufficient profits, they curtail their investment spending and switch more strongly to cost-cutting.

Unfortunately, these are precisely the two devices that squeeze profits further. Individual cost-cutting is helpful, but general cost-cutting is self-defeating because, looking at the business sector as a whole, firms essentially cut into each other's revenues. Micro logic turns macro logic on its head.

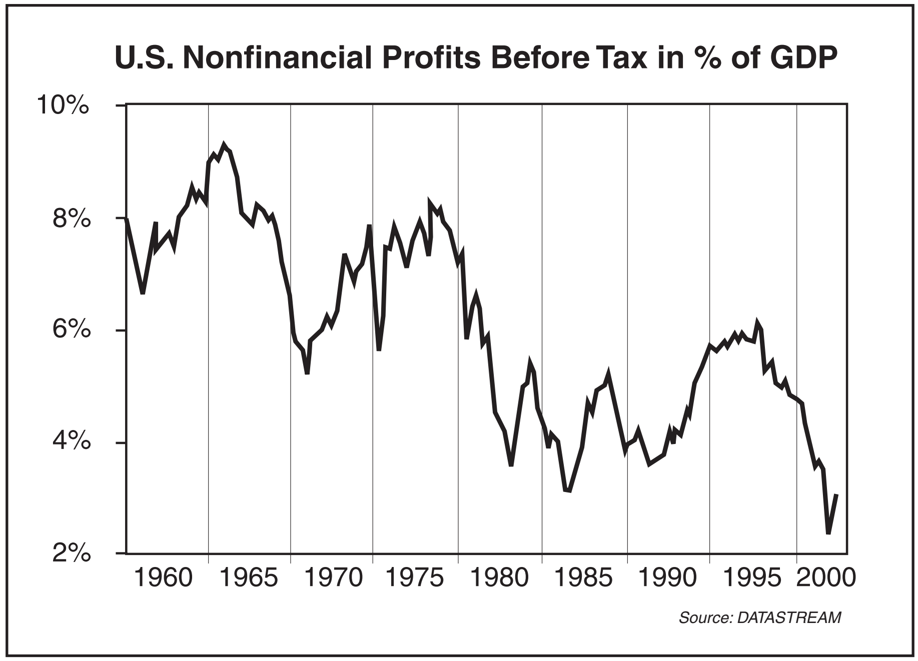
This realization, implicitly, raises two further questions; first, the causes of this protracted profit slump; and second, its successful treatment and removal.

First to the facts. There is a lot of talk and writing about improving profits. Compared with the particularly depressed profit level of the fourth quarter of 2001, immediately following the Sept. 11 attack, profits have improved. But making the customary annual comparison with the third quarter of 2001, the quarter prior to the attack, nonfinancial profits are down from $358.7 billion to $321 billion in the third quarter of 2002.

Certainly, the profit plunge has slowed during 2002. All the same, we don't think that this can give any reason for optimism about profit prospects. Recoveries from recession are typically a profit bonanza for businesses. An actual decline during this phase, as has happened, suggests deeper-seated, long-term profit problems.

In the last letter, we presented a chart showing the development of nonfinancial profits as a share of GDP since the 1960s. What it revealed was a progressive, dramatic profit deterioration over the whole postwar period. In view of the central importance of the profit question, we have decided to reproduce this chart.

As we stressed, this chart definitely discloses that the U.S. economy has a long-term, structural profit problem that didn't start in the late 1990s but in the early 1980s. It went generally unrecognized that the profit gains in the wake of the strong economic recovery that unfolded during the decade were unusually weak.



DEFLATION?

Finally, the question of poor profits is being widely discussed. In the consensus view, profits in the U.S. economy are exposed to four major profit depressants: *first,* rising real pay for workers; *second*, lack of pricing power as reflected in new lows in inflation rates; *third*, weak global demand; and *fourth*, savage international competition due to a global excess of industrial capacity.

For many American economists, these influences are altogether boiling down to a general, global deflation, more precisely, to a profit deflation that has translated into a protracted deflation of investment volumes and investment values. We prefer these precise definitions.

Thinking these arguments over, our first problem is that the U.S. economy's dismal profit performance (see the above chart) actually started in the early 1980s, when none of the present depressants were yet at work. Deflation is, of course, the nightmare experience of the Great Depression in the 1930s. But we have to point to some drastic differences in the economic and financial situation in America between then and today.

Between 1930–33, America's money stock imploded, contracting by 23%. Over the same period, consumer prices declined by more than 30%. For sure, that was deflation, savage deflation. This time, money and credit supply have been exploding and continue to do so. Consumer prices are up against a year ago by 1.5%. Considering these conditions, the word deflation really explains absolutely nothing.

THE WORLD'S PROBLEM: EXCESS SAVING

In the last letter, we quoted John M. Keynes with the remark: *"The whole matter may be summed up by saying that a boom is generated when investment exceeds saving and a slump is generated when saving exceeds investments."* For us, this remark precisely defines today's key economic problem of Japan and Continental Europe.

Economic growth in these countries has always been structurally geared to capital investment and exports, matched by high rates of saving. But the former high investment propensity of their business sectors has sharply weakened in relation to savings rates of around 10% of disposable income. At the same time, a stagnating and aging population is limiting the need for residential building.

The net result is a chronic gap in domestic demand. Responding to slower demand growth and falling profits, businesses have been cutting both their labor costs and their investment spending, but for the economies

as a whole these cuts in business spending have inherently translated into lower business revenues and profits.

For a while, Europe and Asia were able to fill the resulting domestic demand gap partly with higher exports to the United States. But as U.S. demand continues to weaken, this is becoming more and more questionable. Without a meaningful increase in their own capital spending in sight, they will continue to struggle with sluggish economic growth. Germany's more pronounced weakness has its obvious, additional source mainly in economic, financial and fiscal post-unification strains.

An alternative solution would be to adjust savings downward to the lower investment ratio by policies that boost consumption. Considering that capital spending is sure to lag for a long time to come, this would be the most reasonable solution. But we don't see it happening. These countries lack both the necessary consumer mentality and the aggressive lending institutions that abound in the Unites States.

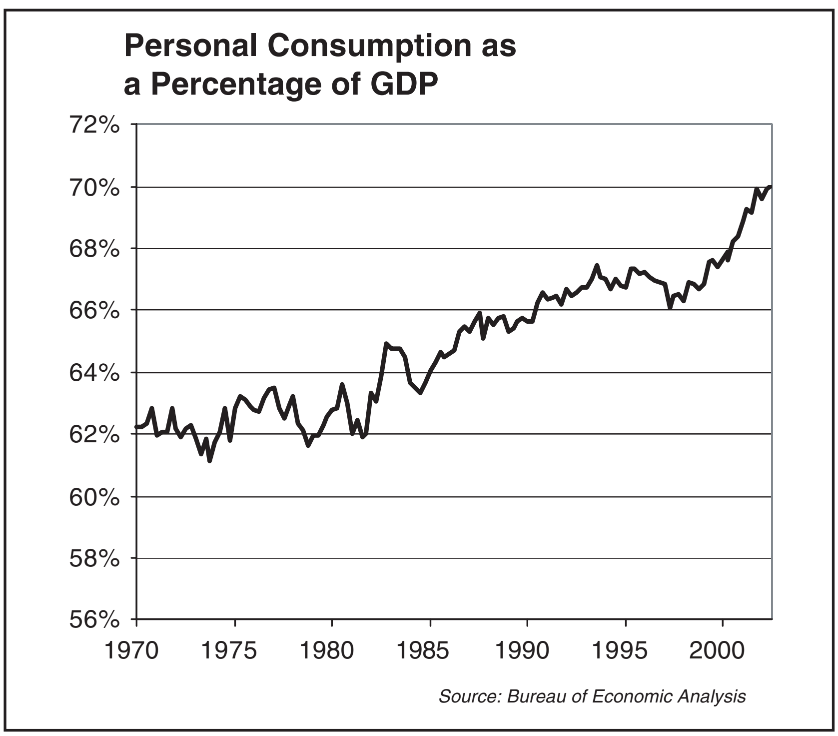
AMERICA'S PROBLEM: EXCESS CONSUMPTION

For good reasons, the world keeps looking hopefully at the United States to lead them out of the global economic doldrums. American policymakers and economists comply comfortingly with optimistic growth forecasts. Even the mere possibility of a double-dip is generally discarded.

Seeing no alternative, there is an overwhelming willingness around the whole world to believe them. We regard this as misplaced optimism. It is true that over the past few years U.S. policymakers have proved an unequalled and unsurpassed capacity to generate demand growth. But the trouble is that it has been and continues to be extremely unbalanced demand growth, weighted in the extreme toward consumption.

The highly visible result that nobody cares to notice is a progressive steep rise in consumption as a share of GDP. In the late 1970s, this share was 62%; in the late 1980s, it increased to 66%; and during the second half of the 1990s, it soared to 70% of GDP. But as a share of current GDP growth, it shot up to 90% and higher. All these numbers are in current dollars.

For years American policymakers and economists have been boasting of the drastic restructuring of the U.S. economy. These figures, of course, confirm this claim. What very few people realize, however, is that what effectively happened was a massive restructuring of the whole economy towards unprecedented consumer spending levels.



For sure, this policy was successful in propelling GDP growth. But boosting consumption at the expense of investment and the trade balance is definitely not the kind of structural restructuring that ranks in economics as a desirable and positive structural change. The economist who still thinks of future implications can only express his horror about such a kind of restructuring.

Behind this positive appearance, corporations and consumers have ravaged their balance sheets with unprecedented recklessness in borrowing. Its counterparts have been dislocations and distortions of unprecedented size both in the economy and its financial system. As a result, U.S. economic growth has become heavily dependent on the perpetuation of its asset bubbles.

In his lectures to the London School of Economics in 1931, Hayek explained the various kinds of dislocations that lead to economic crisis. One of them was that disproportional increases in consumption, lowering the savings rate, would either produce inflation or curtail the sustainable rate of capital formation. Depression begins when the rate of net investment starts to decline, which in turn induces a decline in consumption. Net investment has been very weak in the United States, and is now falling. Putting it into the colloquial language of today: Excess consumption crowds out investment.

PROFITLESS CORPORATE STRATEGIES

Yet there is still another question of great importance to be asked in the face of this development, and that are its implication for business profits. We have been pondering for some time whether and to what extent the U.S. economy's particularly miserable profit performance of the past few years has its causes in the particular governmental and corporate policies of this time. Thinking it over, we have come to the conclusion that there is, in effect, a direct connection. There must be.

Answering this question requires a macroeconomic perspective. Profits arise from specific macroeconomic flows of funds. As we have repeatedly stressed and explained, from the macro perspective, the corporate strategies that have gained the upper hand over organic growth through capital investment in the United States during the past years as the supposedly better means to raise shareholder value — such as cost-cutting, downsizing, mergers and acquisitions — are completely unsuited to improve profits. To the extent that these devices take place at the expense of new investment, overall profitability is eroded. Cost-cutting, on the other hand, only reduces purchasing power.

Tracing profit sources, it is necessary to distinguish between two kinds of business expenditures: spending that is expensed (salaries, wages, rents, interest, depreciations, etc.), and spending on tangible assets that is capitalized in the balance sheets. All expenses reduce profits; all capitalized expenditures increase overall profits.

Looking at the business sector as a whole, net fixed investment is generally the largest and most important profit source because it adds to overall revenues without generating immediate expenses. No expense is incurred until depreciations set in.

The point of crucial importance to see is that the merger and acquisition mania and cost-cutting mania are no substitute for capital investment. In contrast to net new investment, they add nothing at all to overall business revenues. While they appear profitable from the perspective of single firms, they are completely profitless from the macro perspective. In actual fact, they have seriously undermined corporate profitability through their destructive effects on balance sheets and the economy's structure. Soaring corporate indebtedness has been financing less and less productive, tangible assets.

But what about the consumer spending boom? Why didn't that create greater profits? It certainly cushioned the decline of profits, yet it largely failed because it brought another major profit-killer into play — the soaring trade deficit. For lack of domestic capacities to meet the soaring consumption demand, a very great part, if not the greatest part, of the soaring consumer demand ended up with foreign producers, boosting *their* profits instead.

THE GREATEST THREAT: DOLLAR COLLAPSE

We constantly read that the U.S. economy, though weakened, is nevertheless in better shape than the rest of the world. We vehemently disagree. America's extraordinary borrowing and spending excesses have created a thoroughly false impression of the economy's health and strength simply because they created more GDP than in other countries.

But the final result of all those borrowing and spending excesses is an unprecedented vulnerability of the economy and above all of its financial system. Saying this, we think in particular of the dollar. There is an unbelievable complacency about its inbred strength, yet in the 1980s, it crashed under far more favorable conditions both on trade and capital account.

The biggest negative difference in the dollar between then and today is the astronomic size of foreign dollar holdings, having accumulated during the 1990s to $8,000–$9,000 billion. This compares with foreign dollar asset holdings of about $200 billion during the 1980s.

It is nightmarish to think of the possibility that U.S. capital inflows will increasingly lag the stubbornly high trade deficit. Plainly, it is in process, though in slow motion. Nevertheless, it is progressively weakening the dollar, in particular against the euro. Yet considering the extremely low interest rates and the poor corporate profits that America has to offer to investors, we are mystified that capital inflows are apparently continuing at a high level.

In the past, these negatives for foreign investors were largely or even more than offset by gains on the rising dollar. Now, however, substantial and growing dollar losses in the United States come on top of very poor investment returns. We would have expected a virtual capital flight by now. Instead, large, though receding, capital inflows continue. This has but one reasonable explanation: longer-term expectations for the U.S. economy and the dollar remain optimistic.

For us, the whole U.S. economy and its financial system remain a bubble waiting for the needle that will prick it. That needle will probably be gross disappointment of the general, rosy expectations for economic recovery in 2003 and the associated return of the bull market in stocks.

CONCLUSION:

America produces an unexampled plethora of economic statistics. The underlying idea certainly is that the most complete and most detailed information is helpful and important in assessing economic developments. European economists used to have very little esteem for this American speciality. Mr. Hayek, the Austrian, emphasized that the value and success of statistical research depend primarily upon the guidance through a sound theoretical conception.

To us, the whole discussion about the U.S. economy and the world economy is sheer, indiscriminate number crunching that makes no difference in importance between data and questions.

In any case, there prevails a preconceived idea that the U.S. economy has excellent fundamentals and therefore does not have any serious problems. The savings collapse, the profit carnage, the investment slump, all these massive structural distortions and dislocations in the economy's structure find little or nil attention in the discussion. The monstrous current-account deficit, approaching an annual rate of $500 billion, is the innocent counterpart of foreigners eager to invest in the United States.

A lot of energy has been devoted to whether there will be a double-dip into recession. This is the wrong question. What matters, instead, is whether capital spending will rebound after its steepest decline in the whole postwar period. This is also a question that can be answered with reasonable foundation from the available data.

If yes, the U.S. economy has a chance for a sustained recovery. If not, it will be Japanese-style near-stagnation and sub-par growth for years to come. We think the prevailing conditions speak overwhelmingly for the latter.

THE RICHEBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by Agora Publishing Inc.
Laura Davis, Group Publisher
Associate Editor, Richard Barnard
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For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (800) 433-1528, or from outside the U.S. by calling (203) 699-2900. Fax (410) 454-0403. Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.